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Session 102PD
Introduction to Group Disability Income Reinsurance

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Summary: Uses of reinsurance with Group Disability Income (DI) are covered. Topics include:

- *comparison of excess reinsurance versus first-dollar quota-share (i.e., description, advantages, and disadvantages from the cedant and reinsurer point of view),*
- *variables used to determine the price of the reinsurance,*
- *the effect of various types of reinsurance on claims volatility of both the cedant and reinsurer,*
- *treaty provision (i.e., recapture provisions and rate guarantees), and*
- *value-added services provided by reinsurers (i.e., actuarial, claims, underwriting, and distribution).*

Mr. Michael D. Lachance: I am president of Disability RMS, a Portland, Maine-based disability reinsurer, specializing in turnkey group disability reinsurance. John Wiggin is president of Integrated Disability Resources, which was formerly Integrated Disability Management, based in Connecticut, and specializes in facultative-type reinsurance. Jeff Babino is a vice president of The Smith Group, which is also based in Portland, Maine. The Smith Group specializes in automatic reinsurance and disability consulting services.

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This is listed as a panel discussion; however, our presentations will be done in a round-robin style as we discuss various topics that we've selected. We hope this will better highlight the differences among the three different types of reinsurance arrangements.

The topic areas that we've selected are as follows. First, we will describe the different types of reinsurance arrangements paying particular attention to the typical type of client who might be suitable for that type of reinsurance arrangement. Second, we'll discuss the relative advantages and disadvantages of the various types, both from the ceding company's perspective and from the reinsurer's perspective. Additionally, we'll discuss some of the issues that might be associated with each type of program again from both companies' perspectives. Next, we will describe the pricing methodology for the various reinsurance arrangements and some of the factors that might impact pricing. Then we will highlight some of the major treaty provisions that are currently prevalent in the market and review some of the value-added services that each type of reinsurer can provide. Finally, we will spend a few minutes on current market dynamics and how they might impact the various types of reinsurance arrangements that are currently available.

What is turnkey-facultative reinsurance? There are three factors that we use to determine a traditional arrangement. They are: (1) full service, (2) facultative, (3) quota-share.

From a full-service perspective, turnkey reinsurance originated as a method of adding additional distribution capacity for a direct writer of long-term disability (LTD) insurance. This would allow the direct writer to expand their market share. From the client company's (ceding company's) perspective, being a distributor of the reinsurer's product allows them to increase their revenue base without adding a lot of expertise and expense to support it. As a result, every function that must be performed to properly service the customer is available by the reinsurer except the payment of sales commissions and customer billing.

Let's take a look at the facultative aspect of turnkey arrangements. Since it was viewed as additional distribution capacity and the ceding company had very little expertise, most of the underwriting was performed by the turnkey reinsurer. Typically, the sales quotation would originate in the ceding company's sales office, then travel through the client's home office underwriting area to the reinsurer's underwriting area where the underwriting would actually take place. Then, the quotation would go back out to the sales office, the same way that it came in and packaged with any other product lines that the ceding company might be quoting at the same time. Today, it is more likely that the ceding company will have authority

to do some of the underwriting in its own underwriting shop. For example, a case with under 200 lives could be underwritten by the ceding company, and larger cases sent to the reinsurer for underwriting.

Ceding companies typically reinsure a high proportion (quota-share) of the claims risk. It is common to see 50% quota-share and likely that 80% or 90% of the business could be reinsured, particularly if it's a new product line for the ceding company. Recently, we have seen an increase in the use of a combination arrangement which utilizes quota-share and excess together. This is particularly true with smaller companies who desire to limit the volatility of financial results for the line of business.

The typical turnkey client is a small or medium-sized LTD producer with $0-30 million of LTD in force. That's a "ball park" figure. It is possible that a larger company could want turnkey services for a variety of reasons. However, it is best-suited for a company which is just entering the marketplace, interested in becoming an LTD producer, a new entrant to the marketplace, or somebody who is looking for an ancillary product to provide to their sales force. Some national companies use a turnkey arrangement but it is more typical among regional carriers. Turnkey clients usually have a strong lead product, such as medical, and their primary focus is premium growth and product diversification. Again, they want very little risk exposure. They want to reinsure 50% or more of the risk, though they may have some expertise in their companies. This expertise may be one or two people who were either involved in claims, underwriting or pricing of an LTD product at some point while working for another carrier before they joined this ceding company.

John will now review some of the facultative aspects.

Mr. John Wiggin: The facultative is usually targeted to more medium or larger cases or sometimes selected industries or selected markets. The reinsurer will typically underwrite each facultative type of situation on a case-by-case basis. The targets where you would see facultative-type reinsurance would be the larger risk, the specialized risk, or the risk where there are specialized services. In the case of disability, the degree of case management varies quite a bit, and I think this has a big impact on the cost of a claim and the results of the claim. So there are a number of risks that want some very specialized case management activities. One area that we're seeing more of is block buyouts or claim buyouts. These would all be typical situations where you would see some facultative-type arrangements and again, it's for both the risk protection and specialized services.
Generally, the market that we see for facultative is the established disability players. We don't see too much from the nondisability players, although we occasionally get

a request. For the most part, it's the well-established companies that are looking to do a risk that maybe is a little bit out of their comfort zone. We'll move on to Jeff Babino who will cover automatic disability reinsurance.

Mr. Jeffrey E. Babino: Automatic disability reinsurance is written on an excess-of-loss, quota-share and stop-loss basis. I would say that 90% of the automatic business is probably excess and quota-share, or a combination of the two. I've seen very few stop-loss programs out there. There are a few problems with stop-loss. First, how do you "set the sun" on the deal? In other words, with a long-tail risk, how do you do a final accounting for a year's worth of claims. Second, you usually need a protracted disability agreement because there will be years when you don't have a claim. You could have a claim in the first year and need a protracted arrangement in order to recoup your losses.

Automatic disability is best suited for mature, sophisticated disability companies, and that may or may not be an oxymoron, depending on your perspective. It's essential that the heart of automatic disability reinsurance is a follow-the-fortunes approach within specific operating parameters. Automatic disability reinsurers spend a long time in the underwriting and claims departments, reviewing the direct writer's pricing and product to make sure that we can live with his or her day-to-day operating parameters. Then, if we have risks that fall outside of those operating parameters, we deal with those on a facultative basis.

Mr. Lachance: Let's move on to the potential advantages and disadvantages of doing business under the three forms of reinsurance. The greatest advantage of a turnkey program to the client company is quick, easy, low-cost market entry into the business. A good turnkey reinsurer will have on-the-shelf prices, on-the-shelf-products, and services available so that the ceding company can get in very quickly and very easily. As a result, it is sometimes difficult to gain ownership or commitment from the client company over the long term. Another advantage is access to disability expertise and resources. On the other hand, this may create a dependency on the reinsurer which makes it difficult to develop in-house expertise within the client company. If the client wants to be a recognized LTD player, they need to be really focused on the product line.

Access to market information and product comparisons are other advantages of a turnkey relationship. This is particularly true when the reinsurer is doing direct underwriting for their clients on the street. It gives a good idea of what is happening in the market, e.g. which companies are being aggressive and which are not. However, it may be easy for the larger LTD carriers to sell against you. Your sales force may not be as sophisticated and since they probably don't know the product

as well, it's easy to talk circles around them in the marketplace. This may be offset by the ability to package sales or cross-sell many products. Some of the large LTD carriers lack a complete product package and this may be used to advantage by those companies that do.

Another major advantage from the client perspective is the security of knowing that you have a partner with expertise and a common interest in managing the risk. The existence of high quota-share percentages creates an incentive for the reinsurer to be focused on the business and reduces the risk of volatility for the direct writing company. On the down side, the potential exists for cost inefficiencies, which we'll talk about a little bit more when we discuss pricing dynamics. These cost inefficiencies usually do not arise because of high reinsurance premiums, but rather, because of difficulties with cost allocations for the ceding companies. Should allocations be on the basis of gross or net (i.e., after reinsurance) premiums? As a result, we sometimes see client companies trying to cover a disproportionately high amount of overhead expenses with their LTD product even though it is an ancillary product with a high level of reinsurance.

Now I will discuss the potential advantages and disadvantages of a reinsurance partnership from the reinsurer's perspective. In a partnership, you not only share in the business success, but also, in its failures. Every company that wants to get into a new market will always have high first-year sales expectations. Very few companies will actually deliver on these expectations. Therefore, the reinsurer needs to assess a prospect's potential for success in the LTD marketplace. Sometimes, a reinsurer may make significant investments in a client only to have a change in management or a change in the company's direction prevent them from getting any return on that investment.

One potential advantage is risk control and predictability. Turnkey reinsurance is really more like managing a direct business because of active day-to-day involvement with the client. However, it does become very resource intensive. The reinsurer need productions staff to do the underwriting, to handle claims, to do compliance, and the support staff for things like data input for inputting census on active case quotations. The resource intensity can be particularly high for a client who is new to the business. The reinsurer will spend a lot of time helping the client with filings, assessing their strengths and weaknesses, and trying to create a good training environment without creating service inefficiencies. Because of day-to-day production levels, a good administrative system and in-house systems resources become very important.

Mr. Wiggin: I think as we go through the various types of reinsurance, you'll see a little bit of overlap, but each one is slightly different. The advantage to an insurance company in using facultative arrangements, first and foremost, is a potential to increase a company's return on equity (ROE). Typically, companies will take a ceding fee up front and because of lower surplus needs the potential ROE return is a little bit higher. Obviously, the company may use facultative reinsurance to decrease the volatility of the risk, as well. The facultative arrangement can be on a specific case, a specific industry, or a specific market segment in which the company feels they have too much exposure. As Mike said earlier, you get a lot of market knowledge in areas that your company lacks expertise. We do an awful lot of research and development type of work. So I think facultative arrangements are particularly good if a company wants to look at new and different markets that they have not tried before. It gives them a chance to test and try different things without having to make a full investment.

Perhaps a good example of that is the managed disability market, which requires a significant up-front investment in resources, training, systems, expertise, knowledge, etc. A company that is unsure about whether it wants to be an established, managed disability player, is a good candidate for a facultative type arrangement to see how much is involved before making an enormous investment.

A number of companies have good-sized distribution systems, and yet, their target markets tend to be very focused. So facultative arrangements can be used to maximize the growth and greatly expand the potential market that a sales force can work in. This decreases the sales overhead and some of the other costs because you can get more premium without the investment or the risk. I've seen some companies dramatically increase their sales by using facultative approaches.

One final advantage that I did want to touch on is that companies can take over small blocks of business, or certain blocks of business, which starts to free up capacity within a company enabling them to provide different services and to potentially do more managed disability. They need time to do training and get knowledge down the ranks. Sometimes with a full workload, it's difficult to train and develop existing staff. We have had some specific requests to take sections of the underwriting department or claims department and train them under facultative types of arrangements. With facultative arrangements, we are concerned about achieving balance and diversity. The reinsurer, like the insurer, doesn't want a predominance of one risk, one industry, or one piece of business dominating the results. So look for quite a bit of volume, either from one company or from several companies.

In our experience, the quality of case management varies very dramatically from one company to another so there does need to be a clear definition of who is going to do what role, particularly on the claim side. In addition, there needs to be pretty clear expectations in terms of how claims are managed and who's going to do what. We'll get into a little bit more of that when we discuss pricing. Direct writers sometimes have trouble admitting weaknesses. This may be a little bit strong but I think there are certainly a lot of companies that feel they're pretty adept at everything. I think there is some reluctance to do outsourcing. Facultative reinsurers want to come in and be an asset and a resource that an insurer feels comfortable using, by tapping into that knowledge, and expertise. It's not always perceived that way internally. So communications throughout the organization need to be especially clear. Finally, if you're getting into a really specialized area, particularly managed disability, there may be a need for pretty good integration of particularly systems. That can take some time and the reinsurers are looking for pretty strong commitment, in terms of volume and relationship duration because it's a pretty significant investment that a reinsurer does not want to do just for one case here or one case there.

Mr. Babino: From an automatic-excess perspective, the advantage for the ceding company is that the cost is less than facultative on a relative basis because of the essential nature of the agreement. We don't have to maintain an underwriting department. Our infrastructure is relatively smaller, and the interactions between the direct writer and the reinsurer are fewer, particularly if they work within the agreed-to operating parameters. It stabilizes loss experience from a size perspective. The attachment point limits exposure on the entire disability portfolio, provided again, that the ceding company writes business within treaty guidelines. There's ease of administration because we're following the fortunes of the client and we do not do a lot of exception processing. The direct writer gets access to our disability expertise and experience.

Sometimes a client with an automatic treaty in place wants to introduce a new product. One way of achieving this is to reinsure it on a quota-share basis. This allows the disability carrier to introduce a new disability product, defer most of the risk and get access to the reinsurers experience, expertise, and advice. A good example of that may be a voluntary product where the direct writer doesn't really have the expertise, wants to introduce it, and wants to share its costs with the reinsurer. Quota-share also stabilizes loss experience, both from an incidence and a size perspective because there's reinsurance protection from the first dollar of risk.

Automatic-excess reinsurers need to maintain a relatively small staff when compared to a turnkey or private label type operation. It's not a production shop. There's not

a lot of facultative business that we have to do, provided that we've underwritten the client appropriately up front and have confidence in the various components of their disability operation. It also provides the automatic reinsurer with the opportunity to work with top disability carriers and experienced disability professionals. The major advantage of quota-share for the reinsurer is direct involvement from dollar one, so they have "skin in the game" to create a risk management incentive for the direct writer. From an automatic-excess standpoint, if you had a $20 claim with excess of five, the insurer would incur a $5 claim, and the reinsurer will incur a $15 claim. With a 60/40 quota-share arrangement, and the same $20 claim, the insurer would incur a $12 claim and the reinsurer would incur an $8 claim. So quota-share really gets the direct writer involved from $1 and creates much more incentive for them to be managing that piece of business.

From the ceding company perspective, automatic-excess only covers business that falls within the operating parameters, and may specifically exclude certain classes of risk. Examples may be doctors, lawyers, Indian chiefs, or whatever. In a quota-share arrangement, the ceding company cedes a larger portion of presumably profitable business; therefore they may forego more of the profits of the business. From the automatic-excess reinsurer's viewpoint, it is a very price-competitive market, which I'm sure a few members of the audience can attest to. Pricing is more complicated in quota-share because we actually evaluate the entire disability operation of the ceding company as part of our pricing mechanism. The quality, completeness, and consistency of the data provided to quote or renew is suspect, and we really have to sift through it to make sure that we're dealing with information that's going to have an effect on the risk and allow us to price it accordingly. From a quota-share standpoint, one issue is how to approach a renewal increase. You really can't raise the price of a specific attachment point. You can play with the ceding allowance or you can try to impact the pricing structure, underwriting guidelines or do claims management training, but it's difficult to really have an effect on a quota-share arrangement at renewal.

Mr. Lachance: We will now move on to pricing. In pricing a turnkey program, we are basically looking at the same variables you would normally look at on a direct basis. Typically, the reinsurer has a set of rates that it will provide to the client company, probably on a diskette, or at the very least, provide them with the methodology for calculating base rates on individual cases. Also, the reinsurer will provide the client with a set of underwriting guidelines to provide consistency in underwriting. The primary factor is claim costs with appropriate variations by age, sex, elimination period, plan design features, income or anything that the reinsurer thinks is an appropriate factor to use in rating the risk. SIC and region factors are

prevalent today, more than they were a few years ago. The other key factors to consider in pricing are expenses and profit.

Jeff commented earlier that an automatic program should be cheaper than a turnkey program. I think the potential certainly exists for this to be true; however, there is also potential for coordinating services between client and reinsurer so that there is no cost overlap. This efficiency then keeps the overall cost to the consumer in line with other companies' expense rates. It is very important that the total expenses of both reinsurer and insurer fit within the pricing parameters of direct companies with which they are competing; otherwise, the price won't be competitive. It's very important to avoid duplicating services between the reinsurer and the direct company. This is easier for a new entrant because they have very little expertise and are highly dependent on the reinsurer. But as that company grows, and their expertise evolves to a higher level, it becomes more of a challenge to make sure that those services are being performed in the right place, either by the reinsurer or by the direct writing company, but not by both.

Mr. Wiggin: Mike was talking about overlap of services. This is a concern on the facultative side as well. Though I will say that often times a facultative case is actually underwritten twice—once by the direct writer and once by the reinsurer. That's not necessarily bad because you end up with two sets of eyes looking at the same case. This can provide comfort to both that we're looking at the same thing and looking at the same potential volatility and fluctuation. It's not too much of an additional expense and I think it avoids making mistakes on a particular risk. That's a relatively minor piece of the whole expense equation. We obviously want to make sure that roles are clarified as to who is going to do what.

I mentioned earlier that price is going to be very sensitive to case management and/or plan provisions. I think that some companies have filed contracts that are pretty good, in terms of allowing management of a claim while others are very traditional and don't allow as much management. When you combine the policy provisions that are filed with the case management capabilities, you can get variations of 15-20% in price. If you have a very rich type of policy, with very little claims management versus a little tighter policy with very aggressive claims management, there will be a significant difference in terms of pricing. Sometimes a facultative reinsurer can help a direct writer look at a risk in a different way, identify problems, and determine ways to write a piece of business on a competitive basis.

Mr. Babino: From an automatic-excess basis, you want to measure the effect of a renewal strategy and rate increases on the reinsurance on a prospective basis and measure the change in mix of business by average monthly indemnity. This is very

important in an automatic-excess arrangement. For example, let's assume that we have an automatic-excess agreement of $7. The insurance premium is based on a percentage of covered payroll while the reinsurance premium is a percentage of premium. What happens if an employee's $10 salary increases by 10%, assuming no offsets to keep things simple. The insurer collects 10% more premium and incurs 0% more risk, because the claim is already over the attachment point. The reinsurer collects 10% more premium and incurs 33% more risk. So it's definitely something that a reinsurer has to take into consideration when doing prospective pricing. You really have to price for that trend. Our rates are normally based on gross written premium. If you don't price for that salary increase, then a year from now or two years from now, if someone wants a two-year guarantee, you're going to be underpriced.

From a quota-share perspective, the pricing follows the direct side methodology. Again, it's following the fortunes. We spend a lot of time analyzing a direct writers pricing methodologies and whether or not they're adequate. The question is, How do you effectively place a rate increase with a quota-share arrangement going forward if you don't control the pricing? You have to try to effect the pricing, underwriting and risk management of that direct writing company.

Now I will discuss automatic disability reinsurance's effect on claim volatility. Reinsurance decreases claim volatility for the direct insurer. The pooling of clients lessens the volatility for the reinsurance companies. So the more clients and the more spread of risk that you have, provided that you price it appropriately, the lower your volatility will be. However, reinsurance cannot fix a poorly performing LTD block by itself if it is priced appropriately. It does not make the risk more or less profitable. There are some companies out there that would like to think that entering into a reinsurance agreement will in fact make their business more profitable. I'm hoping that it won't because reinsurers are there to make profits as well. So, if a direct writer is pricing to achieve a 10% profit margin, it is only fair that the reinsurer who is following the fortunes of the direct writer should get 10% as well.

Mr. Lachance: Jeff alluded to the situation where a large direct writer with an automatic treaty is interested in getting into a new product. They may choose to use the consulting services offered by their existing automatic reinsurer. Alternatively, they may seek out the services of a turnkey reinsurer. This gives them some time to develop expertise in the product though day-to-day involvement with the reinsurer.

Let's look at some of the major treaty provisions involved in each of the types of reinsurance programs. The coinsurance percentage is fairly simple. It is determined

by the level of risk protection that the ceding company is looking for. The next three: the term of the treaty, the termination provisions, and the recapture provisions are probably the three most negotiated aspects of the treaty. The term of the treaty refers to any minimum period of time in which the treaty cannot be cancelled. If the ceding company is going to be taking advantage of the reinsurer's turnkey services up front, then the turnkey reinsurer will be making a significant up-front investments. In this situation, a minimum level of premium production or some minimum time period may be appropriate to provide the reinsurer an opportunity to recover those expenses. For turnkey, the typical recapture period in the industry right now is about two years from the date of treaty termination. Unlike some of the other types, turnkey reinsurance is essentially on a case-by-case basis, so it's easy to terminate a treaty for prospective business, but not recapture the existing business right away. For example, say somebody gives notice of termination on December 1 for new business. Notice of termination may not necessarily allow them to recapture their existing book of business depending on what the terms of the recapture provision are in the treaty.

Another key element is the risk transfer process. This defines which, if any, cases will be underwritten on an automatic basis and which cases will be facultatively underwritten. The premium remittance process includes any rate guarantees. Turnkey reinsurers determine rate guarantees on a case-level basis based on underwriting guidelines and the needs of the customer. The treaty will also address claims management and claims reimbursement processes, legal processes in the event of a disagreement among the parties and reporting requirements. As I mentioned before, the turnkey reinsurer administers a lot of the business on its own systems. In some cases, we have slightly more accurate information than the ceding company because we've done the underwriting in our own shop.

Mr. Wiggin: The provisions on the facultative side aren't that much different from what Mike described for turnkey. Again, it's pretty common to have two- and three-year rate guarantees. I think reinsurers, therefore, really prefer contracts that are longer. Obviously, I'd like to go through a renewal cycle or two renewal cycles, so that if there's any adverse experience on the initial rate guarantees, there is also an opportunity to recover from that in the third, fourth, and fifth years. As Jeff said, reinsurers are looking for win-win situations. I think that we typically like to do some assessment right up front in terms of goals and objectives, so that everybody is on the same page. There is obviously a preference not to create a facultative situation for just one case. Ideally, there is a strategy and a plan defining where facultative will be used. There may be different types of arrangements such as profit sharing arrangements or performance-based fees based on results, performance, etc.

The recapture provisions vary from immediate recapture to one or two years. I see pretty often a desire for immediate recapture. The existing open LTD claims are always an issue to deal with, particularly if there's an existing piece of business that stays with the company. Some of the claims for this particular customer may be managed by the reinsurer and new claims managed by someone else. If a reserve transfer can be negotiated, so that all of the claims are in one place, that is preferred. But these are usually dealt with on a one-case-at-a-time basis based on the facts of each situation.

Mr. Babino: I don't have a lot to add except that, in the automatic market, recapture is essentially immediate. There are some other recapture provisions out there, but I think the trend is definitely for immediate recapture. The other major issue that we're dealing with are multiple-year, not two-year rate guarantees. Direct writers are asking for them; sometimes they're getting them, and sometimes they're not. Those are the major treaty provisions that we're dealing with out there.

Mr. Lachance: From the standpoint of services offered as a turnkey reinsurer, as I mentioned before, it's basically like running your own direct business. Therefore, the services offered run the whole gamut from product development, contract language, and compliance services, including the potential of filing a product for a client company. The turnkey reinsurer will certainly have either a rating methodology or a rating diskette that they can offer for client use. There will be marketing support, including assistance with developing a marketing strategy to improve the client's chances for success. Marketing materials and training are certainly available to the client's sales force to improve their product and market knowledge of LTD and how to sell it. From an underwriting perspective, underwriting guidelines are available, and we can assess the need for training on an ongoing basis. Frankly, a lot of the training is done "on-the-job." By working closely together on a day-to-day basis, the client's underwriters become more knowledgeable and adept at underwriting LTD. Some clients will let us do all of their underwriting for them. This prevents inefficiencies that might otherwise exist if the work-flow included a trip through the client's underwriting area. But in the more typical situation the client has some form of home office underwriting contact. Claims are usually handled on an advice-to-pay basis. The client does most of the leg-work needed and forwards the information to us for a claims opinion. Our claims examiners assess the claims and advise our clients how to proceed on a particular claim. We also do extensive training and perform claim audits.

Actuarial services include rating, filing support, and financial reporting assistance. We can provide clients with filing packages that are ready to go. The client writes a check with a cover note and sends it directly to the states for filing. Reserving

assistance and development of management information systems are also provided. Most of our clients don't have information systems that are geared towards managing the LTD product. We spend a considerable amount of time working with them to upgrade their systems so that they can get access to the management information that is needed to adequately manage a book of LTD business.

Mr. Wiggin: On the facultative side, we really see three or four areas of value added. The first is underwriting. Oftentimes the reinsurer will have specialized knowledge in particular areas: speciality groups like the physician market, larger cases, which tend to be underwritten quite differently than the smaller cases, voluntary coverages, or blue collar coverages. So we run the gamut of specialized requests. I think the biggest area of value added services is in the case management and managed disability areas. A number of companies are very new to STD, in particular. For the larger companies, when they are doing STD, almost everything comes in electronically or telephonically to a nurse. That's foreign to a number of players, so there's a lot of real value added services just doing telephonic medical management of a claim and then providing a network of resources. The network could be a variety of different things. It could be some specialized units like a staff of physician specialists, a site-based management unit, medical case-management units, on-site rehabilitation (at the place of employment or at the home, but it's community-based case management), as well as a contracted network of providers. I think managed care is pretty common on the medical side and on the workers' compensation side; it's a little less common on STD and LTD, but it is coming. There has also been a big impact, for example, on the compensation side as a result of using provider networks. I think that is all coming to us as well. So I think the reinsurer can provide capacity, and volume and create a provider network for direct writers to use that will have a big impact on the bottom line results.

Systems is a particularly big issue. As companies get more and more into specialized areas and we move to more of a managed environment, systems become fairly important. So a number of companies I know out there are looking for, in addition to claim payment systems, good reporting systems, and case management systems, etc. Then there's the whole host of other services which Mike touched on: filing, strategic planning, actuarial services, policy forms, filing, and new product development. I hope this gives you a general feel of what's out there.

Mr. Babino: In the automatic market, it used to be that automatic disability reinsurance was strictly a financial deal. The players got tired of competing entirely on price, so they started to differentiate themselves by some of the value-added services that are provided. Some of these are service guarantees from an actuarial

perspective: pricing, reserves and financial reporting analysis. In claims we provide audits, training and consulting on complex claims or ERISA appeals. We perform underwriting audits, training and exceptions or facultative type services. From a marketing perspective, some of the services we provide or that are provided in the market are product development, distribution training, and research and development.

Mr. Lachance: Moving into current the market dynamics, looking at the LTD reinsurance market in total, there is quite a bit of risk capacity that is generally available today. The number of LTD reinsurance competitors out there is quite significant. Although the dynamics might be changing a little bit for various players around the table, there has been a niche orientation specializing in each of the three areas we have been discussing: turnkey, facultative, and automatic. In the turnkey market, the focus is on the client's success. We are a little less concerned with what the reinsurance market is doing. We are more focused on what the direct side market is doing, so that we can properly position our client companies to be successful in selling LTD on a profitable basis. Also, the ceding company will choose the reinsurer with the unique blend of services, risk capacity, and personality that they're looking for on a long-term basis.

Mr. Wiggin: I think my comments aren't going to be directed to facultative per se, but just the market in general. I am seeing a fairly strong trend, moving from indemnity to managed care, just like the medical and the compensation. In an indemnity disability product as the emphasis being on income replacement, whereas in the managed care disability product, I think the emphasis is a lot more on the quality of the health care and return-to-work initiatives. Income replacement is still there, but the emphasis is far more on return-to-work and quality health care. I am continuing to hear about and actually see more activity in the integration market as the integration of compensation and disability or medical and disability. There are a number of players that are starting to be aggressive in terms of various forms of integration. I do expect that the medical players and the compensation players are going to be very, very active in the traditional STD/LTD market. They are going to bring many resources that we are not used to, to bear. Disability as a cost is relatively low compared to other products, particularly compared to medical. So I think there is the probability that we could be facing some different pricing dynamics when the compensation players and the medical players get firmly entrenched in this business. I do think that there will be, as a result of that, some consolidation, from a manufacturing point of view. There are an awful lot of companies who essentially manufacture and develop their own product. I think over time there may be more emphasis on sales and marketing and more outsourcing to try and gain access to specialized services and specialized

manufactured products. I saw a lot of this movement in the large case market, but I'm seeing it start to trickle down into the medium and small case market and I think it's going to start effecting both the services and the price. Be on the look-out for what may be coming.

Mr. Babino: From an automatic disability perspective, there's a lot of pressure on price out there and the clients are winning. They are getting a relatively low price for the protection that is provided in the marketplace. There seems to be an abundance of capacity. Between the reinsurers and the lobsters in Portland, Maine, you can barely cross the street. There are new players coming into the market all the time and some of these are from overseas. So we have global competition that's coming into play. I expect that there will be some consolidation, so there may be some people out there who are trying to choose their partner, before the partner is chosen for them! That's essentially what is going on in the automatic market.

Mr. David M. Campbell: Actually, I am on the financial side, rather than the reinsurance side, so forgive me if I seem like I should know some of this stuff and don't. Both questions that immediately came to mind pertain to the facultative side. When it was mentioned that the reinsurer usually does the case-specific underwriting, is that from the perspective of underwriting a case for the direct writer or just doing a case-specific pricing for the reinsurer's share of the risk on that case? The second question on facultative was in relation to recapture. You made a distinction between recapture versus a transfer of liability on the open claims. I was wondering if the cancellation in that sense was a distinction between new cases written by that company versus an ongoing premium on cases that have previously been reinsured and how that all works in relation to open claims versus future premiums for two groups of business.

Mr. Wiggin: First on the underwriting side, we typically would do a reinsurance price. But, at the same time, we would have a recommended street price, so that's the format that we usually would use. We usually have a pretty good idea of what the overall expenses are and we're trying to create a competitive street rate, so we will give both. We will do the underwriting from both perspectives, but our primary focus is to provide a reinsurance quote.

In terms of the recapture, there are a couple of different situations. If the reinsurance contract terminates, but the particular customer, let's say ABC Manufacturing Company stays in force, the ceding company still maintains the risk and is going to keep the ongoing premium. You still have these existing open claims and each situation is a little bit different. There are situations where the reinsurer is doing the majority of the case management, and after a contract

terminates, it may be that case management moves somewhere else. You'll have the ABC Company that has some of its claimants managed by A and some of their claimants managed by B, which can be an awkward situation. When trying to price for this you want to roll up the total experience. So there's different ways of handling that, one is a reserve transfer, which would be used to try and move all of the claims. That's usually priced as a separate deal. The new business going forward usually goes to either the ceding carrier or a new reinsurer and the existing business or the existing claims is dealt with as a separate pricing. If I'm looking at replacing another reinsurer, I usually would do two quotes, one for the existing claims and one for the business going forward.

Mr. Frederick R. Brown, III: One of the things that you didn't touch on was litigation risk and the sharing of and dealing with litigation risk, both contractual and extra-contractual. I wonder if each of you can just speak to how that's handled.

Mr. Lachance: On a turnkey basis, unless the client company has done something to create a litigation risk that wouldn't exist otherwise by making a mistake or doing something that we didn't agree to, we follow the fortunes of the client company. Our treaties specifically say that if the client follows our advice, then we will follow their fortunes. To the extent that they vary from the advice that we've given them the treaty language says that this risk belongs to the client unless we decide to make an exception based on the facts and circumstances of the case in question.

Mr. Wiggin: I don't have a lot to add to that. There is that there is a pretty big difference between public groups and private groups. I think that underwriting towns, cities, counties, and states are particularly problematic because you don't have the ERISA protection. So the threat of litigation and punitive damages in particular are quite a bit higher in the public sector than on the private sector. That's an area that we all need to approach real cautiously. In terms of facultative, we approach it in the same way as Mike outlined. There's some difference, depending on who has the majority of the claim decision-making authority, i.e., who's making the claim decision about the majority of legal risk. In a number of our situations, we're actually making the claim decisions, so we'll take more responsibility for the claim decision.

Mr. Babino: From an automatic standpoint, we don't have a lot of control over what the direct writing company is going to do on a particular claim situation, but we do request or require that we be notified in the event of claims litigation. We'll take a look at the claim and decide whether or not we want to participate or follow the law suit. If we don't participate, then we would commute the claim and essentially buy out our liability.

Mr. Thomas Kirner: I'm from the non-reinsurance part of UNUM. No one discussed market conduct. To date the group disability business has been relatively free of scrutiny; at least there have been no lawsuits under market conduct. Eventually our turn will probably come. How does a client in a facultative or a turnkey reinsurance operation scheme show themselves that they're not going to be damaged under market conduct? Generally, these group representatives are not terribly knowledgeable about disability and they probably don't know who is going to get covered and who is going to get their claim paid.

Mr. Lachance: From a turnkey perspective I've seen or heard of situations where companies with supposedly sophisticated sales representatives have said some crazy things. I don't see that the risk is dramatically different. We spend a great deal of time training the sales forces for our client companies, when we put them in business. It is one of the risks that every business runs, and I'm not sure what we can do to control that.

Mr. Wiggin: I think we are a little bit more isolated from that risk. We've tended to deal with some of the medium and larger cases, directly involved in the proposal presentation, the RFP presentation, with a lot of direct contact with the broker and/or customer making sure there's a good understanding of exactly what is sold or attempted to be sold. We're trying to be particularly careful because, oftentimes, we're recommending plan changes, policy changes, and case management changes that are different than what they may be used to. We're trying to create a different solution and therefore a different claim experience than maybe a company has had in the past. So I think communication is particularly important and I think that's a good point. You can't emphasize enough the importance of good communications up and down the line and that you have knowledgeable and trained people handling everything from an underwriting perspective and from a claim perspective.

Mr. Babino: We are not directly involved in the sales situation, but I'd like to add to what John said. Whenever we do a training program for underwriters, claims people, or actuaries, we will send the outlined training program to the direct writer. We will have them review it themselves and have the legal department review it, so that there's no issue in the event that we provide some information that isn't consistent with their approach to the market.

Mr Lachance: One other comment I'll make on the turnkey side is that our challenge, in most cases, is getting the client companies to be more aggressive in selling the product in the first place. Because they don't have a lot of knowledge going in, they're scared to say anything other than what's on the script that has been given to them. In some ways that manages the risk from their perspective.

Mr. Kirner: Mike, you mentioned that frequently companies involved in turnkey operations are looking at the package sale as their entree because a lot of players don't have the ability to provide all the components of the package. Sometimes companies are looking at treating customers as economic units in looking at the profitability of the customer overall, and not just the profitability of a specific line of coverage. How would a turnkey reinsurer deal with that issue?

Mr. Lachance: We deal with it directly. The rating methodology that we put together has explicit assumptions about how we want to price individual risks. We have the ability to vary our pricing on a case-by-case basis, however, we're still expecting that in the long run our profitability with those individual client companies will come in on target.

Mr. Babino: From an automatic perspective, part of our review of the rates involves pricing pools.

Mr. Wiggin: Typically they have to come to us to ask for relief as opposed to it being automatic.

From the Floor: John, you mentioned earlier that a public business is an extra risk because it's not covered by ERISA, have you recommended or seen companies putting in their contract required arbitration? If they do, has it worked at all? Has anybody else seen that as an effective way of managing lawsuits?

Mr. Wiggin: I don't have any particular experience with that, but I think that is absolutely on target. I don’t know how effective it's going to be. I think there are a couple of companies that are in the public business that have that, but, I don't have any specific experience as to whether it has been effective or not. On the flip side, there have been some companies that have exited the business for that reason. Some big companies have just said, we're just not going to play in this particular market.

Mr. Campbell: This question comes directly from my role in the valuation and financial end of our company. We've come across a couple situations on blocks of business that we've taken over from other companies recently, where the excess treaty was expressed in terms of the net benefit rather than the gross benefit. I was wondering if that's a common thing. If there's a trend that way or anything along those lines, where the reinsurance is based on the benefit after offsets, rather than the 60% or 70% of salary and then, based on that amount, having the reinsurance almost be proportional to the gross benefit.

Mr. Babino: Excess reinsurance is sold both on an integrated and nonintegrated basis, so it is not uncommon to have a net benefit amount basis.

From the Floor: Do you see a predominance of one versus the other?

Mr. Babino: If you're out there at the $10,000 attachment point, most of those treaties are nonintegrated. The lower the attachment point, the more appropriate the integration.

Mr. Alexander Kogan: I'm curious about the newer companies, particularly the medical companies and HMO type companies coming into the marketplace. How successful have they been in penetrating the market with a turnkey situation? What's the profile of the newer companies that are coming into this marketplace for the first time?

Mr. Lachance: As far as the second part of the question, the profile was described well earlier on. It is typically a company that has a medical product or managed care product trying to leverage their sales distribution by giving them additional products to sell. Typically they're regional carriers, or smaller sized companies. To address your first question, about how successful are they in market penetration, I would say it depends on how you measure success. If you think about it from a UNUM or a Standard of Oregon perspective, the amount of sales that these companies generally produce is a drop in the bucket, compared to what those guys will do in a given year. They measure success one step at a time. If they can generate $1 million of sales in the first year, we would be pretty happy with that. But none of these companies have gotten to the point where they have grown so substantially that they have created problems for the major direct writers. The other distinction is that they tend to have target markets that are slightly different from where the traditional LTD carriers are. So the challenge is trying to put together products and rates that will meet their needs and allow them to become somewhat successful in their own markets as opposed to going head-to-head against the major direct carriers.

Mr. Wiggin: In addition to the medical companies, the compensation companies are trying to be a considerable force going forward. For the most part, they all have pretty aggressive structures that are focused on return to work. My experience that has proven that the compensation companies have actually been quite a bit more aggressive in terms of case management, return to work, safety, ergonomics, preventative, managed care initiatives, provider networks, and so on. They have huge infrastructures that are all dedicated to supporting the workers compensation system. Workers compensation has been an extremely competitive market, and

they're all looking for ways to preserve and maintain their compensation markets and their market shares, as well as to use the infrastructure in other ways that have already been developed to support the compensation system. The one thing that they lack at this point is specific STD/LTD knowledge and the full range of protocols. They tend to have less experience with cancer, heart complications, strokes, pregnancies, and so on. Once they start to figure that out, I think that they will be a fairly formidable force. They are coming into the market with expectations that they will be able to deliver substantially better results than the current STD/LTD players. I don't know whether that will happen. There is that expectation because they have seen dramatic drops in cost on the compensation side. Compensation costs have probably dropped by 30% in some states, over the last three or four years, and I think that there is some expectation that they will have similar success on the STD/LTD side.

From the Floor: There seems to be one major difference between LTD from workers' compensation and perhaps medical too, and that is that no one has to buy LTD, but virtually all employers have to provide workers' compensation. Major employers (with more than 100 lives), probably feel they have to provide some kind of medical. Is there anything in the distribution or marketing that will surprise these new entrants?

Mr. Wiggin: On the compensation side, I think the biggest issue is that distribution is from the property/casualty side. They are not used to dealing with the life brokers or the human resource people. They tend to deal with risk managers. The first barrier is overcoming the obstacles in dealing with human resources vs. risk managers. I think we're seeing less and less of some of these obstacles. I'm getting the sense that some of the walls are actually disappearing, certainly at the small companies, and at the large companies there is more consolidation. I do think that, on the compensation side, they are used to dealing with both full-time and part-time. LTD and STD is only full-time. My experience is that some of these companies are doing an awfully good job, particularly with STD claims. The biggest issue on LTD is that they have good infrastructures set up to do return to work, but return-to-work on the compensation is focused earlier on. It isn't the long-term vocational rehabilitation type where you're really getting someone focused on new opportunities or new job training. They have to learn that vocational rehabilitation is different on LTD than it is on the compensation side. So I think there's a learning process there as well. The medical companies come at it from almost a purely medical point of view. They believe that disability is a medical event, and again, they have to learn the income replacement piece, the return-to-work piece and some of those other pieces. There are certainly some

obstacles and some significant learning issues that both are going to have to deal with.